IN THE UNITED STATES DISTRICT COURT
DISTRICT OF KANSAS

State of New Jersey and its
Division of Investment,

Plaintiff,

v. **Case No. 03-2071-JWL**

Sprint Corporation; William T. Esrey; Ronald T. LeMay; Harold S. Hook; Charles E. Rice; Louis W. Smith; Linda Koch Lorimer; Stewart Turley; DuBose Ausley; Warren L. Batts; Irvine O. Hockaday, Jr.; Arthur Krause; and J.P. Meyer,

Defendants.

MEMORANDUM & ORDER

Plaintiff filed this proposed class action suit on behalf of persons who purchased or acquired Sprint FON common stock or Sprint PCS common stock on the open market from March 1, 2001 through January 29, 2003 (the "Class Period"). In its second amended complaint,[1] plaintiff alleges violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), and the SEC's Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (fraud in connection with the sale of securities); and violations of Section 14(a) of the Exchange Act, 15 U.S.C. § 78n(a), and the SEC's Rule 14a-9 promulgated thereunder, 17

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[1]On April 23, 2004, this court granted in part and denied in part defendant Sprint Corporation and the individual defendants' motion to dismiss the first amended complaint and, in doing so, permitted plaintiff to file a second amended complaint. *See State of New Jersey and its Div. of Investment v. Sprint Corp*., 314 F. Supp. 2d 1119 (D. Kan. 2004). At the same time, the court granted in its entirety defendant Ernst & Young's motion to dismiss the first amended complaint. *See id.*

C.F.R. § 240.14a-9 (proxy statement misrepresentations). Plaintiff also asserts against the individual defendants claims under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), which imposes secondary liability upon persons who control persons primarily liable for violations of Section 10(b) and Rule 10b-5.

This matter is presently before the court on defendant Sprint and the individual defendants' motion to dismiss the second amended complaint (doc. #84). As described below, the motion is granted in part and denied in part.

I. Background

The following facts are taken from plaintiff's second amended complaint and, for purposes of analyzing defendants' motion to dismiss, the court assumes the truth of these facts. Defendant Sprint Corporation is a global communications company that provides local, long distance and wireless services. During the Class Period, defendant William T. Esrey was Sprint's Chairman and Chief Executive Officer; defendant Ronald T. LeMay was its President and Chief Operating Officer; defendant Arthur Krause was Sprint's Executive Vice President and Chief Financial Officer; and defendant J.P. Meyer was Sprint's Senior Vice President and Controller. The remaining individual defendants served on Sprint's Board of Directors during the Class Period. According to the second amended complaint, Mssrs. Esrey and LeMay, who both joined Sprint in 1985, were primarily responsible for transforming Sprint from a rural local telephone company into one of the nation's largest local, long distance and wireless telecommunications companies.

During the Class Period, two classes of Sprint's common stock were actively traded on the New York Stock Exchange–FON common stock (intended to track the economic performance of Sprint's FON Group division) and PCS common stock (intended to track the economic performance of Sprint's PCS Group division). Like many other publicly traded companies, Sprint paid its executives and certain employees, including Mssrs. Esrey and LeMay, a portion of their compensation in the form of Sprint common stock options. This case arises out of events that occurred after Mssrs. Esrey and LeMay exercised certain options during 1999 and 2000. According to plaintiff, Mssrs. Esrey and LeMay exercised options during 1999 and 2000 with an aggregate taxable gain of $287 million. As a result of Mssrs. Esrey's and LeMay's option exercises, Sprint derived significant tax benefits in the form of deductions from its taxable income. Plaintiff does not suggest that the options were improperly granted or exercised or that Sprint acted improperly in taking the resulting tax deductions.

Because the exercise of options results in tax liability on the gain realized thereby, the options exercised by Mssrs. Esrey and LeMay subjected them to significant personal tax liability. According to plaintiff, Mssrs. Esrey and LeMay would have needed more than $100 million in cash, collectively, to pay the taxes associated with their option exercises. Plaintiff alleges that Mssrs. Esrey and LeMay wanted to avoid this tax liability entirely and, thus, approached Ernst & Young, the accounting firm that served as Sprint's auditor, to seek advice as to how to go about avoiding paying taxes on their option gains. Thereafter, Mssrs. Esrey and LeMay purchased from Ernst & Young certain "tax shelters" which were designed to eliminate Mssrs. Esrey's and LeMay's tax obligations with respect to the gains realized through the option exercises. According to plaintiff, the shelters involved a two-part transaction. First, Mssrs. Esrey and LeMay used the options to engage in a swap-based transaction that was designed to turn income from the options exercises into capital gains, which are taxed at a rate of 20 percent rather than the significantly higher ordinary-income rate of closer to 40 percent. The second part of the transaction, according to plaintiff, was designed to appear to generate a loss for tax purposes by raising the costs of the assets–the Sprint shares–through the use of partnerships and trades in currency options.

On September 5, 2000, after Mssrs. Esrey and LeMay had entered into the transactions constituting the tax shelters, the IRS issued Cumulative Bulletin Notice 2000-36, which contained Notice 2000-44. That Notice, in turn, outlined the IRS's position that tax shelters similar to the ones that Ernst & Young sold to Mssrs. Esrey and LeMay were invalid and subject to challenge.[2] Specifically, the Notice stated that the "purported losses resulting from the transactions (and from any similar arrangements designed to produce noneconomic tax losses by artificially overstating basis in partnership interests) are not allowable as deductions for federal income tax purposes." The Notice further stated that participants in such transactions may be subjected to appropriate penalties.

Notwithstanding the IRS's position, neither Mr. Esrey nor Mr. LeMay took any steps to satisfy their tax liabilities. According to plaintiff, Ernst & Young advised Mssrs. Esrey and LeMay not to sell shares to satisfy their tax obligations even though, by that point, Ernst & Young and

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[2]Notice 2000-44 did not address the specific transactions entered into by Mssrs. Esrey and LeMay; it addressed in general terms transactions similar to the ones used by Mssrs. Esrey and LeMay.

Mssrs. Esrey and LeMay knew that the losses generated by the tax shelters would likely be disallowed by the IRS and that Mssrs. Esrey and LeMay would be liable for the taxes due on the exercise of their stock options.

In late 2000, Mssrs. Esrey and LeMay, according to plaintiff's second amended complaint, disclosed their "tax avoidance problem" to Sprint's Board of Directors. In December 2000, Sprint and Ernst & Young approached the SEC for guidance on whether Sprint could "unwind" or rescind the option exercises, thereby nullifying Mssrs. Esrey's and LeMay's tax liability. The SEC advised Sprint that the ramifications of unwinding the transactions would be disastrous for Sprint in that Sprint would lose the tax deductions it had taken upon Mssrs. Esrey's and LeMay's option exercises and, thus, would have to restate its earnings and refile its tax returns to pay back taxes at a time when its cash was limited. Thus, Sprint rejected the possibility of unwinding the option exercises.

According to plaintiff, then, Sprint and the individual defendants knew by March 2001 (the beginning of the Class Period) that Mssrs. Esrey and LeMay had entered into improper tax shelters in an attempt to avoid paying over $100 million in taxes on their option exercises; that the decline in the market prices of Sprint's common stock precluded Mssrs. Esrey and LeMay from satisfying their tax liabilities through the sale of Sprint stock; that Mssrs. Esrey and LeMay were unable to satisfy their likely tax liability and were facing certain financial ruin; and that the only method by which Sprint could bail out its top two executives would have involved materially restating Sprint's results of operations for 1999 and 2000, refiling its tax returns and paying back taxes. Plaintiff alleges that, in light of these facts, it was clear to defendants by the start of the Class Period that there was a material possibility or, more likely, a substantial probability that Mssrs. Esrey and LeMay would no longer be able to run Sprint. As alleged by plaintiff in the second amended complaint, a source close to Sprint was quoted in a *Wall Street Journal* article dated February 6, 2003 as stating "Have you ever heard of a bankrupt CEO?"

Defendants did not disclose any of this information to investors. Instead, as alleged by plaintiff, defendants "boasted" about the expected continued employment of Mssrs. Esrey and LeMay. In Sprint's March 15, 2001 proxy statement filed with the SEC, Sprint stated that it had "entered into new employment contracts with Mr. Esrey and Mr. LeMay, each dated February 26, 2001, *designed to insure their long-term employment with Sprint*, to provide competitive compensation, and to link their compensation to shareholder value." (Emphasis added in plaintiff's second amended complaint). According to plaintiff, this statement concerning the long-term employment of Mssrs. Esrey and LeMay–without any reference to the tax shelters and the "no-win situation they had caused for Sprint"–was misleading when it was made because it was "clearly predictable" that Sprint was going to lose Mssrs. Esrey and LeMay as a result of the tax avoidance problem discussed above.

Between late 2000, when defendants met with the SEC to discuss the possibility of unwinding the transactions, and late 2001, defendants took no action to address the problems presented by Mssrs. Esrey's and LeMay's "tax avoidance problem." In late 2001, however, Mssrs. Esrey and LeMay applied for and received tax amnesty from the IRS and thus were immune from any penalties the IRS might levy if it ultimately concluded that the tax shelters utilized by Mssrs. Esrey and LeMay were invalid. Mssrs. Esrey and LeMay, however, were still liable for any unpaid taxes on the gains realized as a result of their option exercises (again, assuming the IRS ultimately concluded that the shelters were invalid). By this time, however, Mssrs. Esrey and LeMay could not sell their shares to cover their potential tax liability because Sprint's common stock price had declined dramatically such that Mssrs. Esrey's and LeMay's potential tax liability far exceeded the total value of their Sprint holdings. Thus, according to plaintiff, Mssrs. Esrey and LeMay still faced financial ruin as of late 2001.

During 2002, Sprint's Board of Directors held over twenty meetings dedicated to discussing the tax problems and the "dismal financial condition" faced by Mssrs. Esrey and LeMay, as well as the role Ernst & Young played in promoting and selling the tax shelters to Mssrs. Esrey and LeMay. In contrast, the Board held only nine meetings during all of 2000 and only seven meetings during 2001. Notwithstanding these numerous meetings concerning Mssrs. Esrey and LeMay (and, according to plaintiff, the "termination of Esrey and LeMay"), defendants again touted the long-term employment prospects of Mssrs. Esrey and LeMay. In that regard, in Sprint's March 15, 2002 proxy statement filed with the SEC, Sprint stated that it had "entered into new employment contracts with Mr. Esrey and Mr. LeMay, each dated February 26, 2001, *designed to insure their long-term employment with Sprint*, to provide competitive compensation, and to link their compensation to shareholder value." (Emphasis added in plaintiff's second amended complaint). Sprint made a virtually identical statement in a Form 10-K filed with the SEC on March 4, 2002 and in an amended Form 10-K filed with the SEC on March 5, 2002. According to plaintiff, these statements concerning the long-term employment of Mssrs. Esrey and LeMay–without any reference to the tax shelters and the "no-win situation they had caused for

Sprint"–were misleading when they were made because defendants knew by that time that it was inevitable or, at a minimum, a material possibility, that Mssrs. Esrey and LeMay would no longer serve as Sprint's top executives as a result of the tax problems discussed above.

In June 2002, the Board learned that the IRS had begun formally investigating Mssrs. Esrey and LeMay in connection with the specific tax shelters utilized by them.[3] At that time, the Board hired the law firm of Davis Polk & Wardwell to assess what action Sprint should take. By October 2002, Davis Polk & Wardwell recommended to the Board the dismissal of Mssrs. Esrey and LeMay in light of the tax shelter problems and the resulting conflict between Mssrs. Esrey and LeMay and Ernst & Young. During this same time frame, the Board hired an executive search firm to begin searching for a new CEO. Defendants still did not disclose to the public any information concerning the tax problems faced by Mssrs. Esrey and LeMay.

On January 29, 2003, the *Wall Street Journal* reported on its website that both Mr. Esrey and Mr. LeMay were leaving Sprint. In response to this news, the market prices of both FON common stock and PCS common stock fell considerably. In early February 2003, the Wall Street Journal reported that Mssrs. Esrey and LeMay were forced out by Sprint as a result of the tax shelter situation and its resulting effects on the executives' financial condition.

II. Standard Governing Motion to Dismiss Pursuant to Rule 12(b)(6)

The court will dismiss a cause of action for failure to state a claim only when "it appears

[3]The IRS's audit of the tax shelters utilized by Mssrs. Esrey and LeMay is apparently ongoing and no determination has been made about the validity of those shelters.

beyond a doubt that the plaintiff can prove no set of facts in support of his [or her] claims which would entitle him [or her] to relief," *Poole v. County of Otero*, 271 F.3d 955, 957 (10th Cir. 2001) (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)), or when an issue of law is dispositive. *Neitzke v. Williams*, 490 U.S. 319, 326 (1989). The court accepts as true all well-pleaded facts, as distinguished from conclusory allegations, and all reasonable inferences from those facts are viewed in favor of the plaintiff. *Smith v. Plati*, 258 F.3d 1167, 1174 (10th Cir. 2001). The issue in resolving a motion such as this is "not whether [the] plaintiff will ultimately prevail, but whether the claimant is entitled to offer evidence to support the claims." *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 511 (2002) (quoting *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974)).

In the securities context, Rule 12(b)(6) dismissals are difficult to obtain because the cause of action deals primarily with "fact-specific inquiries" such as materiality. *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1118 (10th Cir. 1997) (citations omitted). Nonetheless, "courts do not hesitate to dismiss securities claims pursuant to Rule 12(b)(6) where the alleged misstatements or omissions are plainly immaterial, where the plaintiff has failed to allege with particularity circumstances that could justify an inference of fraud under Rule 9(b)," or where the defendant has no duty to disclose the information allegedly omitted. *Id.* at 1118-19 (affirming district court's Rule 12(b)(6) dismissal of securities fraud case where the defendant had no duty to disclose the information allegedly omitted). Ultimately, when evaluating defendants' motions to dismiss pursuant to Rule 12(b)(6), the court must evaluate "the totality of the pleadings" to determine if plaintiff has stated an actionable claim of securities fraud. *See Adams v. Kinder-*

Morgan, Inc., 340 F.3d 1083, 1092 (10th Cir. 2003) (citing *City of Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245, 1261-62 (10th Cir. 2001)).

III. Discussion

Defendants move to dismiss plaintiff's second amended complaint in its entirety. Specifically, defendants move to dismiss all claims on the grounds that they had no duty to disclose that the termination of Mssrs. Esrey and LeMay was "inevitable" or a "material possibility;" that the claims are precluded by the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 ("PSLRA"); and that the allegations contained in plaintiff's second amended complaint do not permit a strong inference of scienter as required by the PSLRA. Defendants move to dismiss plaintiff's section 14(a) claim for the additional reason that plaintiff fails to allege any causal connection between any transaction for which approval was sought through a proxy statement and any alleged injury. Finally, defendants move to dismiss any claims based on Sprint's statements concerning Mr. Esrey's cancer diagnosis. As explained below, defendants' motion is granted to the extent plaintiff's claims are based on Sprint's statements concerning Mr. Esrey's cancer diagnosis and is otherwise denied.

A. Duty to Disclose

Plaintiff's claims are based on defendants' failure to disclose, in connection with Sprint's statements concerning the long-term employment of Mssrs. Esrey and LeMay, any information about the tax shelter situation and the fact that, as a result of that situation, the termination of the employment of Mssrs. Esrey and LeMay was either inevitable or a significant possibility. Absent an independent duty to disclose, however, nondisclosure cannot serve as the basis for liability under the federal securities laws. *See Grossman v. Novell, Inc.*, 120 F.3d 1112, 1125 (10th Cir. 1997) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988)); *see also In re Time Warner Inc. Securities Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) ("[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know the fact. Rather, an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts."). Courts have recognized an independent duty to disclose in only a handful of circumstances–when disclosure is necessary to make statements that have been made not misleading, *see Grossman*, 120 F.3d at 1125 ("if a defendant makes a statement on a particular issue, and that statement is false or later turns out to be false, the defendant may be under a duty to correct any misleading impression left by the statement"); *Connett v. Justus Enterprises of Kansas, Inc.*, 68 F.3d 382, 385 (10th Cir. 1995) (in order to be actionable, an omission must render *misleading* the affirmative statements actually made) (citing *Jensen v. Kimble*, 1 F.3d 1073, 1077 (10th Cir. 1993)), when disclosure is mandated by statute or regulation, *see, e.g., Backman v. Polaroid Corp.*, 910 F.2d 10, 20 (1st Cir. 1990), and when disclosure is required by virtue of a fiduciary-type relationship, *see SEC v. Cochran*, 214 F.3d 1261, 1264 (10th Cir. 2000) (citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980)).

According to plaintiff's theory of the case, defendants had a duty to disclose information about the tax shelters and the significant possibility or inevitability that Mssrs. Esrey's and

LeMay's employment would be terminated because, in the absence of such disclosures, Sprint's statements about the long-term employment of Mssrs. Esrey and LeMay were misleading. Defendants contend that dismissal of plaintiff's case is appropriate because they simply had no duty to disclose that the termination of Mssrs. Esrey's and LeMay's employment was a significant possibility or inevitable. In that regard, defendants first maintain that disclosure was not required because the termination of Mssrs. Esrey's and LeMay's employment was not under "active and serious consideration" at the times of Sprint's statements concerning the long-term employment of Mssrs. Esrey and LeMay.

Defendants' argument that the termination of Mssrs. Esrey's and LeMay's employment must have been under "active and serious consideration" at the times of the statements before Sprint was required to disclose the information flows from the Second Circuit's decision in *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259 (2d Cir. 1993), a case on which this court relied in resolving defendants' initial motion to dismiss. As the court summarized in its previous order, Time Warner, saddled with over $10 billion in debt as a result of a recent merger, made several public statements about its efforts to find "strategic partners" who would infuse billions of dollars of capital into the company. *See id.* at 262. During the same period of time that the company was making these statements (and other statements concerning the status of ongoing strategic partnership discussions), the company was also considering (and ultimately chose) an alternative method of raising capital–a new stock offering that substantially diluted the rights of the existing shareholders. *See id.* The plaintiffs filed a section 10(b) claim against the company based, among other things, on the company's failure to disclose that it was considering an alternative method of raising capital. *See id.*

The district court concluded that the statements concerning the search for strategic partnerships were accurate when made and that subsequent events did not obligate Time Warner to correct or update those statements. *See id.* at 263. On appeal, the Second Circuit reversed the district court's decision. Specifically, the court held that "when a corporation is pursuing a specific business goal and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration." *Id.* at 268.

Looking to the *Time Warner* case for guidance, this court concluded in its prior order that because plaintiff had articulated during oral argument the theory that Sprint was considering an alternative (indeed, a mutually exclusive alternative–the termination of Mssrs. Esrey's and LeMay's employment) at the time it made statements touting the long-term employment of Mssrs. Esrey and LeMay, plaintiff would be permitted to amend its complaint to clarify that theory and, assuming plaintiff could support the theory with the requisite facts, that the theory was sufficient to survive defendants' motion to dismiss. Now, defendants essentially contend that the allegations in plaintiff's second amended complaint are insufficient, under *Time Warner*, to support the theory articulated by plaintiff during oral argument. That is, defendants contend that the allegations in the second amended complaint, even if true, simply do not permit the conclusion that the termination of Mssrs. Esrey's and LeMay's employment was under "active and serious consideration" in March 2001 or even in March 2002, when the challenged statements were made.

The court disagrees. Assuming that the "active and serious consideration" standard is the appropriate standard by which to measure defendants' conduct, the question of what defendants were considering in March 2001 and March 2002, and to what extent they were considering any particular subjects, is not one that can be resolved on a motion to dismiss. Stated another way, the court cannot say as a matter of law that plaintiff will be unable to prove any set of facts which would entitle it to relief. In the second amended complaint, plaintiff specifically alleges that defendants, by March 2001, knew that Mssrs. Esrey and LeMay had entered into tax shelters in an attempt to avoid paying over $100 million in taxes on their option exercises; knew that the IRS in all likelihood would conclude that the tax shelters were improper and, thus, that Mssrs. Esrey and LeMay would face massive tax liabilities; knew that Mssrs. Esrey and LeMay would be unable to satisfy their tax liabilities through the sale of Sprint stock; and knew that Sprint was not going to "bail out" Mssrs. Esrey and LeMay by unwinding the option exercises.

It is reasonable to infer from these allegations that defendants knew that Mssrs. Esrey's and LeMay's ability to continue to lead Sprint was in jeopardy. *See Smith v. Plati*, 258 F.3d 1167, 1174 (10th Cir. 2001) (on a Rule 12(b)(6) motion, court accepts as true all well-pleaded facts and all reasonable inferences from those facts are viewed in favor of the plaintiff). Whether and to what extent defendants were "considering" the termination of Mssrs. Esrey and LeMay's employment (and, at a more basic level, what type of conduct might constitute "active and serious consideration") are fact questions to be resolved on a motion for summary judgment, if appropriate, or by a jury.

Defendants also maintain that plaintiff's claims must be dismissed because the claims are based on the inaccurate assumption that Mssrs. Esrey and LeMay would be "financially ruined" if the IRS concluded that the tax shelters were improper. According to defendants, Mssrs. Esrey and LeMay were not necessarily facing financial ruin because Sprint considered extending loans to the executives to cover their tax liabilities. In that regard, defendants highlight language in the employment contracts dated February 26, 2001 stating that "It is the current intent of the Board to view favorably the Executive's request for a Loan Arrangement," and that loans could be extended "to pay taxes associated with the retaining ownership of Sprint stock" or "to pay taxes associated with the acquisition of Sprint stock." While Sprint did not ultimately extend such loans, defendants contend that this language shows that any "financial ruin" of Mssrs. Esrey and LeMay was not a foregone conclusion and, consequently, the inference that plaintiff draws in the second amended complaint is unwarranted.

Like defendants' previous argument, the court concludes that this argument cannot be resolved in the context of a Rule 12(b)(6) motion. A reasonable inference can be drawn from the allegations in plaintiff's complaint that tax liabilities of $100 million would, in all likelihood, force Mssrs. Esrey and LeMay into "financial ruin." Despite the fact that Mssrs. Esrey's and LeMay's employment contracts left open the possibility that Sprint would extend loans to the executives, Sprint never did extend the loans and a reasonable inference can be drawn from the allegations in plaintiff's complaint that it was highly unlikely that Sprint was going to extend loans of $100 million to the executives. At the very least, plaintiff is entitled to discovery concerning the extent to which Sprint actually considered extending such loans to its executives.[4]

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[4]In a related argument, defendants assert that plaintiff's claims are based on another inaccurate assumption–the assumption that Mssrs. Esrey and LeMay would necessarily be fired

Finally, defendants assert that they had no duty to disclose the possible or inevitable termination of Mssrs. Esrey's and LeMay's employment because Sprint's statements concerning Mssrs. Esrey and LeMay did not "foreclose the possibility" that the executives might later be terminated. In support of this argument, defendants rely on the Second Circuit's decision in *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Companies*, 75 F.3d 801 (2d Cir. 1996). In *San Leandro*, Philip Morris, through the first quarter of 1993, engaged in a marketing strategy to increase sales of its premium cigarette brands. *See id.* at 805. That strategy consisted of narrowing the price gap between premium and discount cigarettes by increasing the prices of both premium and discount brands and by increasing discount brand prices by an even greater margin to make the discount brands less attractive and thereby induce customers to buy premium brands. *Id.* The plan was unsuccessful and, thus, at the end of the first quarter of 1993, Philip Morris adopted a new marketing strategy that involved reducing the price of its most popular and largest selling premium brand by $0.40 per pack, a move estimated to reduce its earnings by $2 billion in 1993. *Id.* Following this announcement, Philip Morris stock dropped almost 25 percent. *Id.*

The plaintiffs filed a section 10(b) claim against Philip Morris and contended that Philip Morris had a duty to disclose its consideration of the alternative business plan in order to prevent various prior statements from becoming misleading. *See id.* at 804. The Second Circuit affirmed

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because they faced financial ruin. Again, the court cannot resolve this argument on a motion to dismiss. Suffice it to say, the allegations in plaintiff's second amended complaint support the inference that Mssrs. Esrey's and LeMay's personal financial status would affect their continued employment as Sprint's top two executives.

the dismissal of the plaintiffs' complaint, in large part because the Circuit was "concerned . . . about interpreting the securities laws to force companies to give their competitors advance notice of sensitive pricing information." *See id.* at 809. Ultimately, the Circuit held that Philip Morris did not have a duty to disclose the alternative plan because the "single, vague statement" pertinent to plaintiffs' claim (that the company's "main focus this year would be on profits, not market share") "cannot have led any reasonable investor to conclude that Philip Morris had committed itself to a particular marketing strategy and had foreclosed all alternatives." *See id.* at 810.

According to defendants, then, San Leandro requires dismissal of plaintiff's second amended complaint because Sprint's statements cannot reasonably be read to have foreclosed the possibility that Mssrs. Esrey's and LeMay's employment might be terminated. The court rejects this argument. As an initial matter, the *San Leandro* case is readily distinguishable from this one as the Circuit's decision in *San Leandro* was based in large part on its reluctance to require a company to disclose its marketing plans to its competitors. In any event, while Sprint's statements concerning its employment contracts with Mssrs. Esrey and LeMay may not have foreclosed the possibility that at some point in the future Mssrs. Esrey and LeMay might not be employed with Sprint, the statement that the contracts were "designed to insure" long-term employment can reasonably be read to convey the message that, at least in Sprint's view, Mssrs. Esrey's and LeMay's long-term employment was certain. *See, e.g., Webster's Third New International Dictionary* 1173 (1986) (defining "insure" as "to declare to with confidence" or "to promise solemnly"); *American Heritage Dictionary* 667 (2d College ed. 1985) (defining "insure" as to make "sure" or "certain"). Stated another way, unlike the statement in *San Leandro*, Sprint's statement that the contracts were "designed to insure" the long-term employment of Mssrs. Esrey and LeMay could reasonably have led an investor to conclude that the termination of Mssrs. Esrey's and LeMay's employment (at least in the near future) was simply not an option from Sprint's perspective.

In sum, the court rejects, at least at this juncture, defendants' arguments that it did not have a duty to disclose information concerning the possible or inevitable termination of Mssrs. Esrey's and LeMay's employment.

B. Safe Harbor for Forward-Looking Statements

Defendants also move to dismiss plaintiff's second amended complaint on the grounds that the specific statements that plaintiff alleges were misleading constitute "forward-looking statements" protected by the PSLRA's safe harbor provision. *See* 15 U.S.C. § 78u-5. A "forward-looking statement" is defined as:

> (A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure or other financial items;
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> (B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
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> (C) a statement of future economic performance, including any statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;
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> (D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C);

> (E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or
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> (F) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission.

Id. § 78u-5(i)(1)(A) - (F).

The safe harbor has two independent prongs–one focusing on the defendant's cautionary statements and the other on the defendant's state of mind. *See Southland Securities Corp. v. INSpire Insurance Solutions, Inc.*, 365 F.3d 353, 371 (5th Cir. 2004) (citing 15 U.S.C. §§ 78u-5(c)(1)(A) & (B)). Under the first prong, there is no liability if, and to the extent that, the forward-looking statement is "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. § 78u-5(c)(1)(A).[5] Under the second prong, there is no liability if the plaintiff fails to prove that the statement, if made by a business entity, was made by or with the approval of an executive officer of that entity with actual knowledge by that officer that the statement was false or misleading. *Id.* at § 78u-5(c)(1)(B)(ii).[6]

Assuming, without deciding, that the statements concerning Sprint's employment contracts

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[5]Under the first prong, a defendant can also avoid liability if the forward-looking statement is immaterial. *See id.* § 78u-5(c)(1)(A)(ii). Defendants do not raise the materiality issue in their motion to dismiss.

[6]Although the second prong is written as a safe harbor, "the effect is to change the elements of a fraud action" in that actual knowledge of falsity or misleading character is required as opposed to a showing of recklessness as sufficient scienter. *See* 3 Alan R. Bromberg & Lewis D. Lowenfels, *Securities Fraud and Commodities Fraud* § 6.36 (2d ed. 2004).

with Mssrs. Esrey and LeMay fall within the statutory definition of "forward-looking statements,"[7] the court nonetheless denies defendants' motion on this issue. It is undisputed that Sprint did not identify the statements as forward-looking and that the statements were not accompanied by any cautionary statements. Accordingly, plaintiff may properly allege a claim based on these statements if they were made with actual knowledge that they were false or misleading. The court concludes that plaintiff has adequately pled in its second amended complaint that defendants knew that the statements concerning Sprint's employment contracts with Mssrs. Esrey and LeMay were misleading because the statements were made at a time when the continued employment of Mssrs. Esrey and LeMay was in serious doubt. Thus, the court cannot say as a matter of law that defendants are entitled to the protections of the safe harbor. *See In re AOL Time Warner, Inc. Securities and "ERISA" Lit*., 2004 WL 992991, at *19 (S.D.N.Y. May 5, 2004) (denying motion to dismiss on safe harbor grounds where plaintiff pled that defendant either knew or recklessly

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[7]While the court need not decide at this juncture whether the statements constitute "forward-looking statements," the court questions whether the statements would qualify as "forward-looking statements," particularly as plaintiff alleges that the statements were rendered misleading due to Sprint's omissions concerning the tax shelter situation. *See, e.g., In re MobileMedia Securities Lit*., 28 F. Supp. 2d 901, 930 (D.N.J. 1998) ("Allegations based upon omissions of existing facts or circumstances do not constitute forward looking statements protected by the safe harbor of the Securities Act); *accord AES Corp. v. Dow Chem. Corp*., 2001 WL 34367296, at *4 (D. Del. Jan. 19, 2001). Moreover, the statements that Sprint "entered into new employment contracts . . . designed to insure their long-term employment" are arguably statements of present fact rather than forward-looking statements. *See* 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* 477 (4th ed. 2002) (a statement of present fact is not a forward-looking statement subject to the protection of the safe harbor); *In re AOL Time Warner, Inc. Securities & "ERISA" Lit*., 2004 WL 992991, at *19 (S.D.N.Y. May 5, 2004) (prediction concerning rising revenues fell outside the scope of the safe harbor because prediction was combined with statements of existing facts).

disregarded the true financial condition of AOL when he spoke publicly).

Defendants maintain that plaintiff's allegations of actual knowledge in the second amended complaint are conclusory and, thus, insufficient to withstand a motion to dismiss. The court disagrees. Plaintiff has alleged that the defendants knew the potential tax liability that Mssrs. Esrey and LeMay faced; knew that, in all likelihood, the IRS would one day determine that the shelters were invalid and come to collect the liability; and knew that the liability would bankrupt Mssrs. Esrey and LeMay and that, as a result, Mssrs. Esrey's and LeMay's continued ability to lead Sprint was in grave doubt. These allegations, then, "raise the possibility–no greater confidence is possible before discovery"–that defendants knew that circumstances existed that made the long-term employment of Mssrs. Esrey and LeMay questionable (even unlikely) but omitted those circumstances from the statements concerning the long-term employment of Mssrs. Esrey and LeMay in order to (misleadingly) assure investors (who, according to the second amended complaint, believed that Mssrs. Esrey and LeMay's leadership was critical to Sprint's continued success) that Sprint's future included Mssrs. Esrey and LeMay at the helm. *See Asher v. Baxter Int'l Inc.*, 377 F.3d 727, 734-35 (7th Cir. 2004) (reversing district court's dismissal of securities fraud complaint on safe harbor grounds; allegations in complaint were sufficient to raise possibility that defendant had actual knowledge of falsity and no more is required, or even possible, at pleading stage). Thus, the complaint cannot be dismissed under the safe harbor. *See id.*

C. Scienter

Defendants next move to dismiss plaintiffs' section 10(b) and section 14(a) claims on the grounds that plaintiff has failed to allege facts permitting a strong inference that defendants failed to disclose material facts with the requisite state of mind as required by the PSLRA. To satisfy the pleading requirements of the Reform Act, plaintiff "must (1) specify all allegedly misleading statements and the reasons why those statements are misleading, and (2) state with particularity facts giving rise to a strong inference that defendants made those statements with the requisite scienter." *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir. 2003) (citing 15 U.S.C. § 78u-4(b)). The appropriate level of scienter for a primary violation of section 10(b) is "a mental state embracing intent to deceive, manipulate, or defraud, which includes recklessness." *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1259-60 (10th Cir. 2001) (citations omitted). Thus, to establish scienter in a section 10(b) securities fraud case alleging non-disclosure of potentially material facts, plaintiffs "must demonstrate: (1) the defendant[s] knew of the potentially material fact, and (2) the defendant[s] knew that failure to reveal the potentially material fact would likely mislead investors." *Pirraglia*, 339 F.3d at 1191 (quoting *Fleming*, 264 F.3d at 1261). The requirement of knowledge in this context "may be satisfied under a recklessness standard by the defendant's knowledge of a fact that was so obviously material that the defendant must have been aware both of its materiality and that its non-disclosure would likely mislead investors." *Fleming*, 264 F.3d at 1261.[8]

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[8]Defendants concede that the applicable state of mind with respect to plaintiff's section 14(a) claim is negligence rather than fraud or recklessness. *See* 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* 428-29 (4th ed. 2002) (negligence is sufficient to state a claim under the proxy rule's antifraud provisions) (collecting cases). Defendants

In their motion to dismiss, defendants contend that plaintiff does not plead with the requisite particularity facts tending to show that defendants knew that their failure to disclose the significant possibility or the inevitability that the employment of Mssrs. Esrey and LeMay would be terminated would likely mislead investors. The court disagrees. As explained above in connection with defendants' safe harbor argument, plaintiff has alleged facts sufficient to raise the possibility that defendants knew that the long-term employment of Mssrs. Esrey and LeMay was improbable and failed to disclose this information in an effort to convince investors that Sprint's future included its brightest stars, Mssrs. Esrey and LeMay. Defendants' motion is denied on this issue.

D. Section 14(a) Claim

Defendants assert that plaintiff's section 14(a) claim fails for the additional reason that plaintiff has not alleged a causal connection between any transaction for which approval was sought through a proxy statement and any alleged injury. The only transactions for which authorization was sought through the challenged 2001 and 2002 proxy statements were (1) the approval of the appointment of Ernst & Young as Sprint's independent auditor; and (2) the election of Mssrs. Esrey and LeMay as directors. Plaintiff's claim is based upon the appointment of Ernst & Young and, according to defendants, plaintiff cannot identify any loss stemming from this transaction. Defendants, however, raised this argument in connection with their previous motion to dismiss and

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argue in their brief that dismissal of plaintiff's section 14(a) claim is appropriate for failure to allege facts supporting the conclusion that defendants acted negligently.

the court, in resolving that argument, concluded that plaintiff adequately pled a loss stemming from the appointment of Ernst & Young as Sprint's auditor. Thus, for the reasons set forth in the court's previous memorandum and order, this argument is rejected.

E. Statements Regarding Mr. Esrey's Cancer Diagnosis

Finally, defendants move to dismiss plaintiff's second amended complaint to the extent it asserts a claim based on statements made concerning Mr. Esrey's cancer diagnosis. In that regard, plaintiff alleges that Sprint, in a November 2002 article in the *Kansas City Star*, stated that Mr. Esrey had been diagnosed with lymphoma, that his illness was considered "highly treatable," and that Mr. Esrey would "continue his full day-to-day responsibilities while he undergoes chemotherapy." Plaintiff further alleges that defendants made essentially the same statement in a Form 10-Q filed with the SEC in November 2002. According to plaintiff, these statements were misleading because defendants, at the time the statements were made, knew that "Mr. Esrey was about to be fired for reasons unrelated to his unfortunate health condition."

Defendants contend that dismissal of these allegations is appropriate because the statements, unlike the statements concerning Sprint's employment contract with Mr. Esrey, make no reference to Mr. Esrey's "long-term employment," do not purport to make any kind of "guarantees" with respect to Mr. Esrey's future at Sprint and do not suggest how much longer Mr. Esrey would remain with Sprint. To the contrary, the statements suggest only that Mr. Esrey was continuing his "day-to-day" management of Sprint and, according to defendant, there are no allegations that Mr. Esrey was not fulfilling his day-to-day responsibilities at that time. Plaintiff's response to defendants' motion to dismiss does not address these arguments in any fashion. Thus, the court deems plaintiff to have abandoned any claim based on statements concerning Mr. Esrey's cancer diagnosis and defendants' motion to dismiss is granted on this issue.[9]

IT IS THEREFORE ORDERED BY THE COURT THAT defendant Sprint Corporation and the individual defendants' motion to dismiss the second amended consolidated class action complaint (doc. #84) is granted in part and denied in part. The parties are hereby referred to paragraphs 5 and 6 of the First Phase Scheduling Order for further scheduling in this case.

IT IS SO ORDERED.

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[9]In resolving defendants' motion to dismiss the first amended complaint, the court noted that plaintiff had alluded in its briefing to the statements concerning Mr. Esrey's cancer but that it was unclear whether plaintiff intended to state a claim based on those statements. The court then stated that "to the extent an argument can be made that this statement is analogous to the 'long-term employment' statements discussed above, the court will permit plaintiffs to amend their complaint to include these allegations should they choose to do so."

To the extent that plaintiff, in responding to the motion to dismiss the second amended complaint, declined to address the merits of defendants' arguments concerning the statements about Mr. Esrey's cancer diagnosis based on a perception that the court already concluded that the statements would survive such a motion because they were analogous to the "long-term employment" statements, that perception would be inaccurate. Significantly, defendants have presented compelling arguments that the statements concerning Mr. Esrey's cancer diagnosis are, in fact, not analogous to the "long-term employment" statements. Thus, plaintiff's failure to respond is not excused by the court's order regarding the first motion to dismiss.

Dated this 3rd day of September, 2004, at Kansas City, Kansas.

s/ John W. Lungstrum
John W. Lungstrum
United States District Judge